



Explain the cartoons



'THE SAME BOAT'

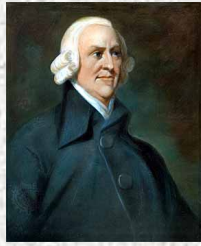
By the end of this lesson I will be able to...



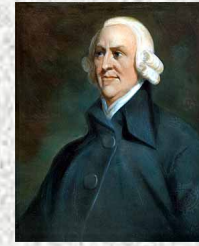
- Define Opportunity Costs / Absolute Advantage / Comparative Advantage.
- Understand how to apply these concepts on an individual and national level.

At an Individual Level





Adam Smith



- *It is the maxim of every prudent master of a family, never to attempt to make at home what it will cost him more to make than to buy. The taylor does not attempt to make his own shoes, but buys them of the shoemaker. The shoemaker does not attempt to make his own clothes, but employs a taylor. The farmer attempts to make neither the one nor the other, but employs the skills of others.*
- (Wealth of Nations; quote cont. later)

Absolute Advantage

- **Individual** – exists when a person can produce more of a certain good/service than someone else in the same amount of time or can produce a good using the least amount of resources.

So....Is Absolute Advantage
the only basis for trading?

What if a person or a nation has an
absolute advantage in producing
everything....would there still be a
reason to specialize and trade?

Yes!

**It's all about
comparative
advantage!**

Comparative Advantage

- A person has a comparative advantage in the production of a product when he/she can produce the product at a lower opportunity cost than can a trading partner.

Opportunity Cost

- Whatever must be given up to obtain an item.

Ex. Instead of playing your Playstation or Wii, you study for your exams (in order to get good grades). The opportunity cost of the computer game has been forgone.



Britney Spears and Comparative Advantage.

- Scientists discover that Britney Spears is the fastest grass cutter in the world. She can cut one hectare of grass in 1hr using only a pair of scissors. Should she change career?



Opportunity costs and Comparative Advantage

- Spears takes 1hr to cut 1 hectare of grass, in that time she could earn \$10,000 by filming a commercial for Diet Coke.
- By contrast, Spears' neighbor, Forrest Gump can cut the grass in 3hrs with a lawnmower or work in McDonalds for \$20.
- Spears has the **Absolute Advantage** because she can do the work in less time. But Forrest has a **Comparative Advantage** because he has the lower **Opportunity Cost**.

	<u>Bake</u> <u>Cakes</u>	<u>Make</u> <u>Pizza</u>
<u>Mr.</u> <u>Mouse</u>	2 cakes/hr.	6 pizzas/hr.
<u>Mr.</u> <u>Davidson</u>	4 cakes/hr.	8 pizzas/hr.

Who has the absolute advantage in producing cakes? Mr. Davidson
Who has the absolute advantage in producing pizza? Mr. Davidson
So, would Mr. Davidson be better off if he specializes and trades?

Mr. Davidson should specialize and trade if he has a comparative advantage (lower opportunity cost) in the production of one of the products.

	<u>Bake Cakes</u>	<u>Make Pizza</u>
<u>Mr. Mouse</u>	2 cakes/hr. (1c = 3p)	6 pizzas/hr. (1p = 1/3c)
<u>Mr. Davidson</u>	4 cakes/hr. (1c = 2p)	8 pizzas/hr. (1p = 1/2c)

Mr. Davidson has a lower opportunity cost in producing cakes; therefore, he should specialize in the production of cakes. Mr. Mouse has a lower opportunity cost in producing pizza; therefore, he should specialize in the production of pizza.

Terms of trade.

	<u>Bake</u> <u>Cakes</u> <u>Davidson will specialize in cakes.</u>	<u>Make</u> <u>Pizza</u> <u>Mouse will specialize in pizzas.</u>
<u>Mr. Mouse</u>	$1c = 3p$ For one cake, Mouse would be willing to pay anything up to 3 pizzas.	$1p = 1/3c$ For one pizza, Mouse will want more than 1/3 cakes.
<u>Mr. Davidson</u>	$1c = 2p$ For one cake, Davidson will want more than 2 pizzas.	$1p = 1/2c$ For one pizza, Davidson would be willing to pay anything up to $1/2$ cake.

Review Question

Robinson Crusoe can gather 10 coconuts or catch 1 fish per hour. His friend Friday can gather 30 coconuts or catch 2 fish per hour.

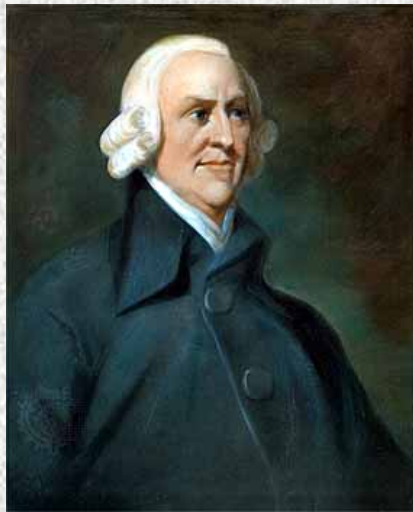
- What is Crusoe's opportunity cost of catching one fish?
- What is Friday's?
- Who has an absolute advantage in catching fish?
- Who has a comparative advantage in catching fish?

On an International Level

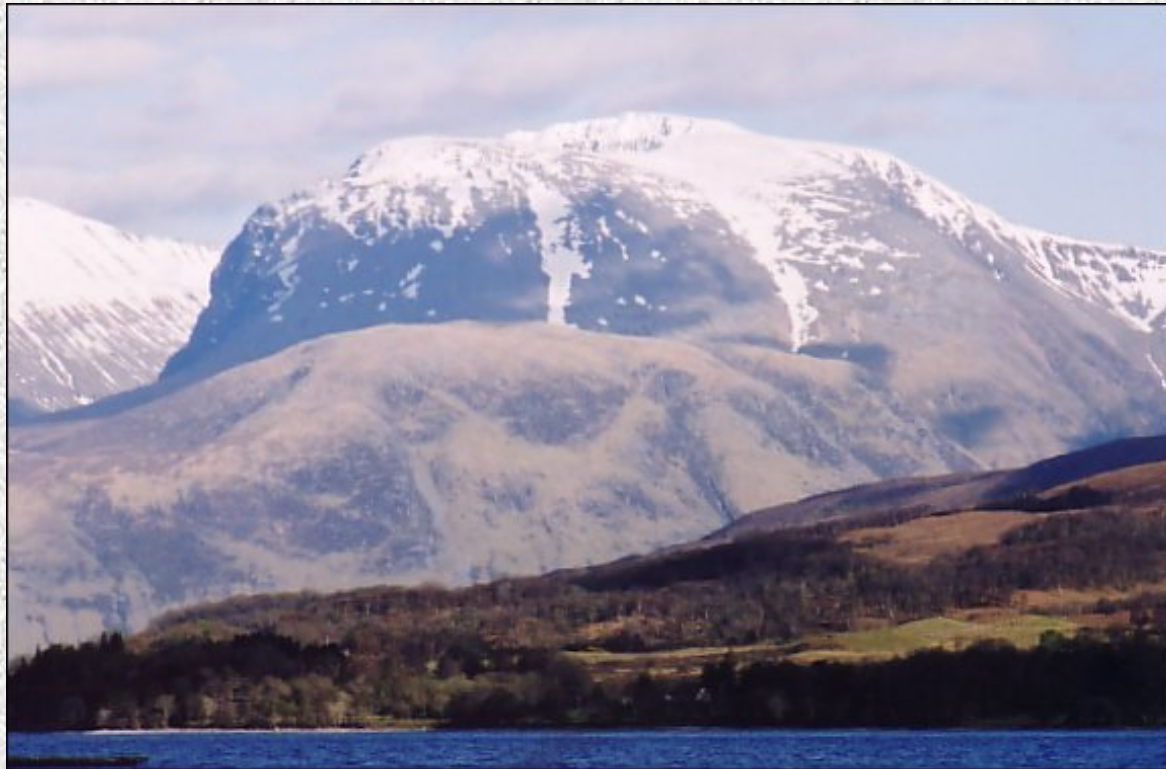


Adam Smith, *The Wealth of Nations*

What is prudence in the conduct of every private family, can scarce be folly in that of a great kingdom. If a foreign country can supply us with a commodity cheaper than we can make it, better buy it of them with some part of the produce of our own industry; (Book IV, Section ii, 12)

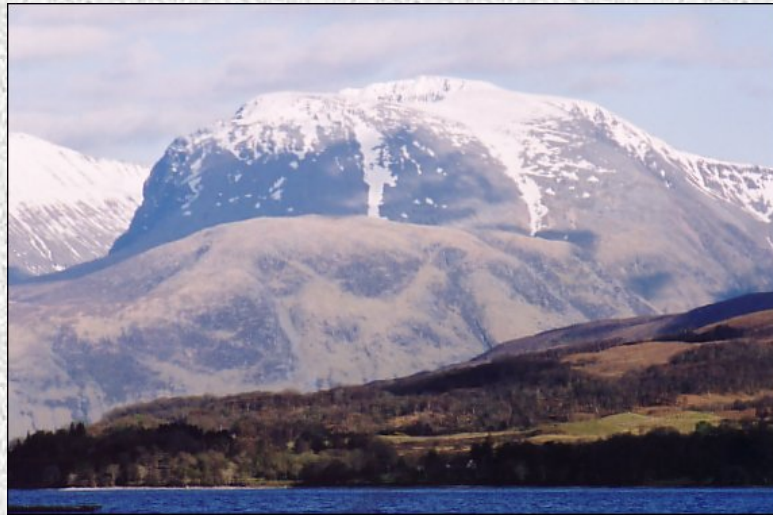
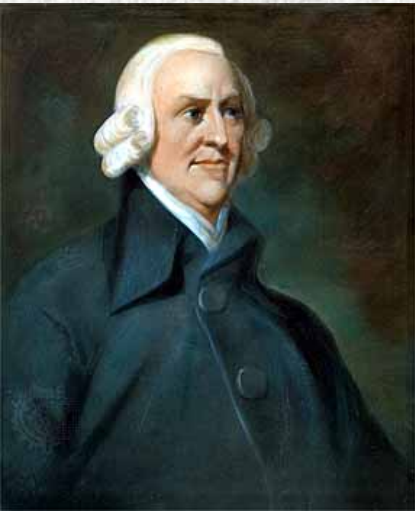


Can you grow grapes and oranges here?



Adam Smith (1723-1790)

- "By means of heated-walls and glass houses on the slopes of Ben Nevis, it would cost them 30 times the price to make French wine. By just buying the French wine from France, Scotland saved twenty-nine thirtieths of the cost and could spend it on other things." (Adam Smith, Wealth of Nations)



Why do nations trade?

- Specialization and trade increase productivity within a nation.
- Because of specialization and trade, there will be a larger global output of goods and services. A larger global output means more income for household. More income means a greater standard of living.
- Everyone can benefit when people trade with one another. Not only can people enjoy a greater quantity of goods and services, but they can also enjoy a greater variety of goods.

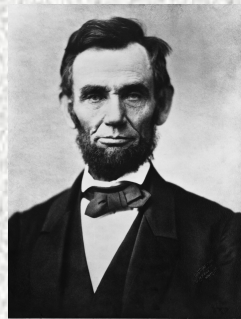
International Absolute Advantage

- **National** – exists when a country can produce more of a good/service than another country can in the same time period or can produce a good using the least amount of resources.

International Comparative Advantage

- A nation should specialize in the production of a product for which it has a lower opportunity cost and trade to obtain those products for which its opportunity cost is higher.

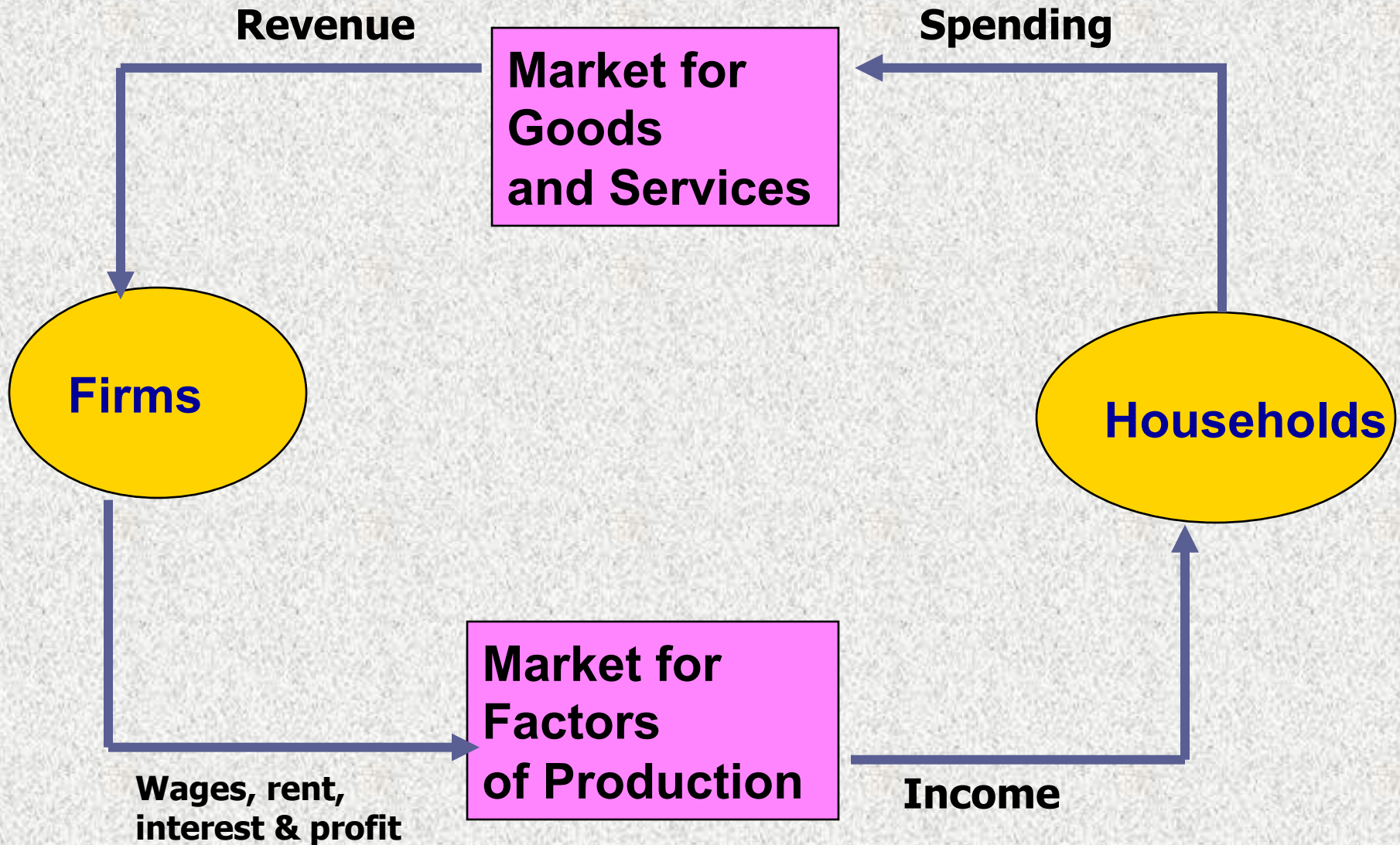
- Abraham Lincoln was once advised to buy expensive iron rails from Britain to finish the transcontinental railroad. He replied, “It seems to me that if we buy the rails from England, then we’ ve got the rails and they’ ve got the money. But if we build the rails here, we’ ve got our rails and we’ ve got our money.”



Sources of International Comparative Advantage

- Differences in climate
- Differences in available amounts of the factors of production (resources)
- Differences in technology

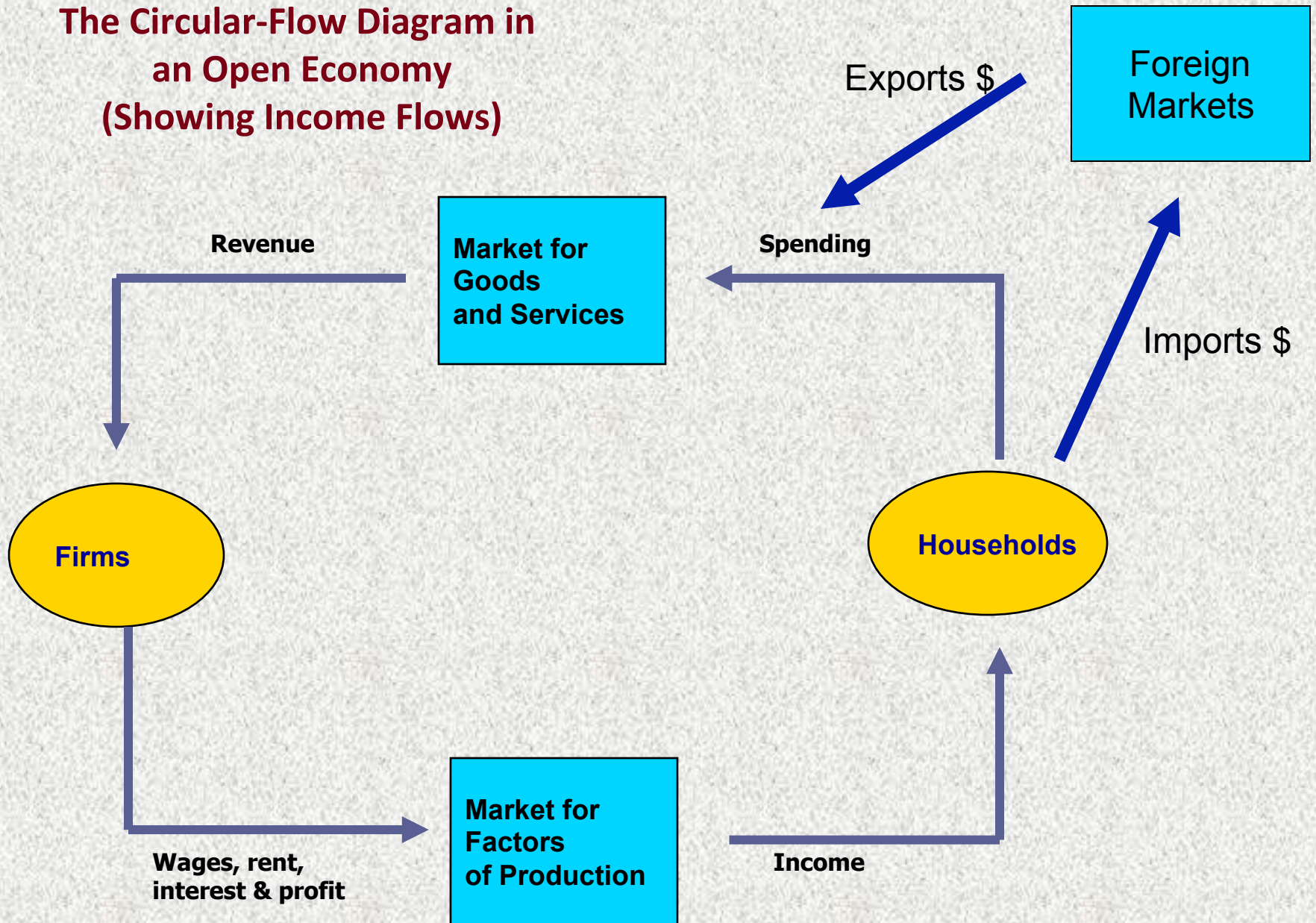
The Circular-Flow Diagram



The Role of Imports and Exports

- **Leakages:** flows out of the circular flow when resource income is received and not spent directly on purchases from domestic firms
 - Imports are a leakage
- **Injectiions:** added spending in the circular flow that does not come out of current resource income
 - Exports are an injection

The Circular-Flow Diagram in an Open Economy (Showing Income Flows)



Important Terms to Know

- If exports = imports, the Circular Flow is in balance.
(the amount of money leaving the country through import buying equals the amount of money entering the country through export selling)
- Usually it is not balanced.
 - A trade deficit occurs when imports are greater than exports.
 - A trade surplus occurs when exports are greater than imports

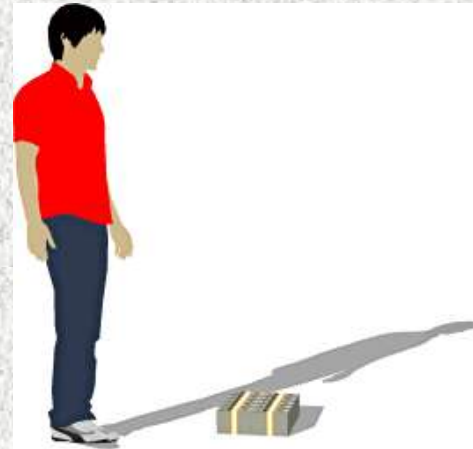
In the USA

- In 2010, United States **exported** \$1,276,994,000,000 goods and \$549,602,000,000 services.
- In 2010, United States **imported** \$2,117,245,000,000 goods and \$405,287,000,000 services.

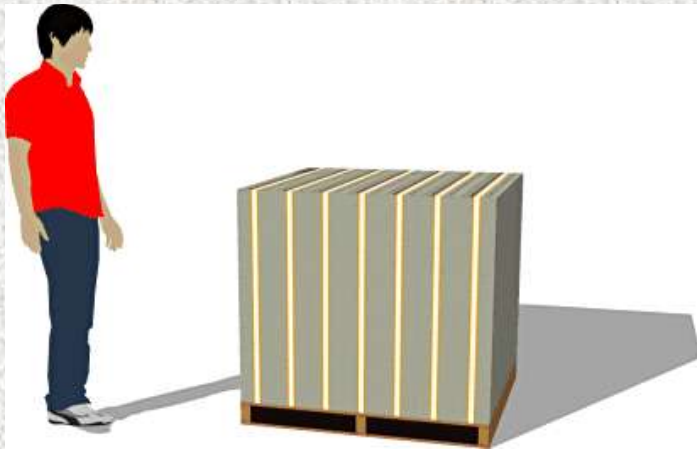
(Bureau of Economic Analysis)



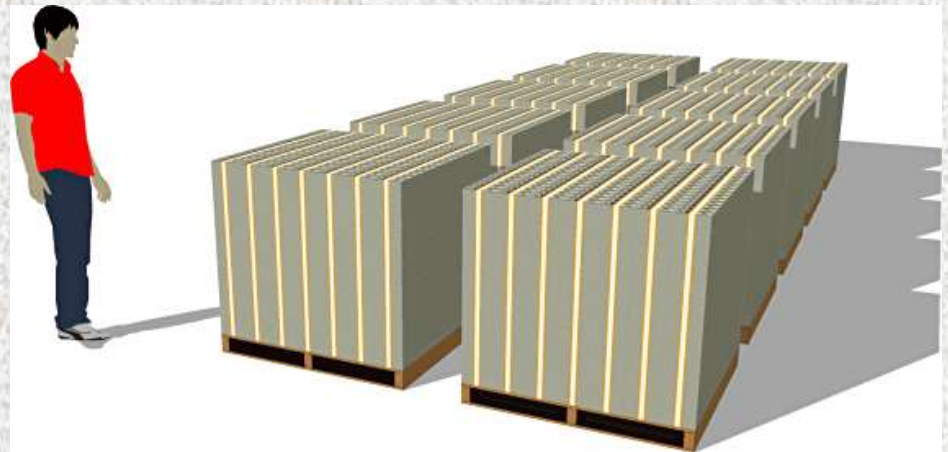
10,000 pounds



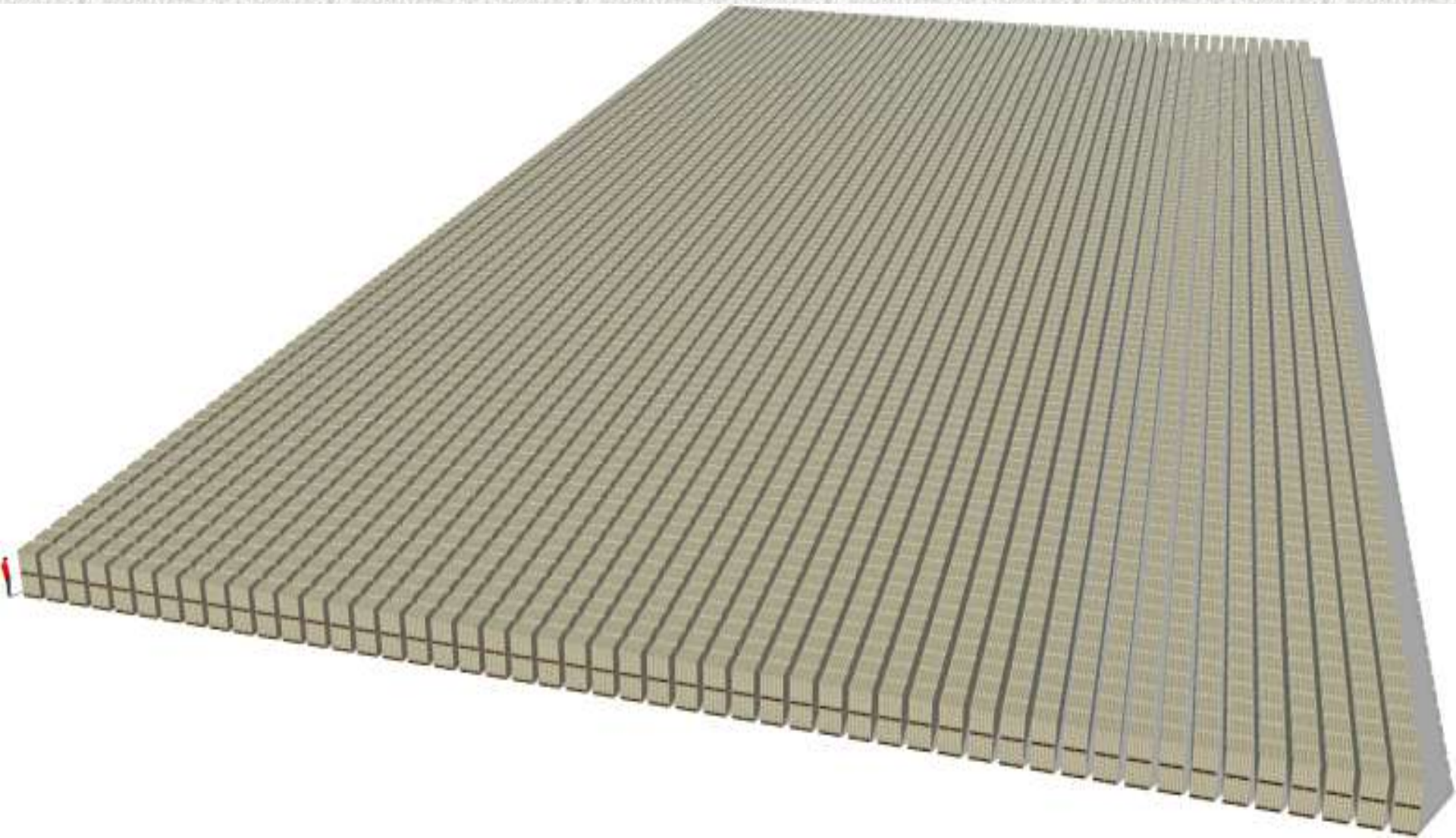
1 million pounds



100 million pounds

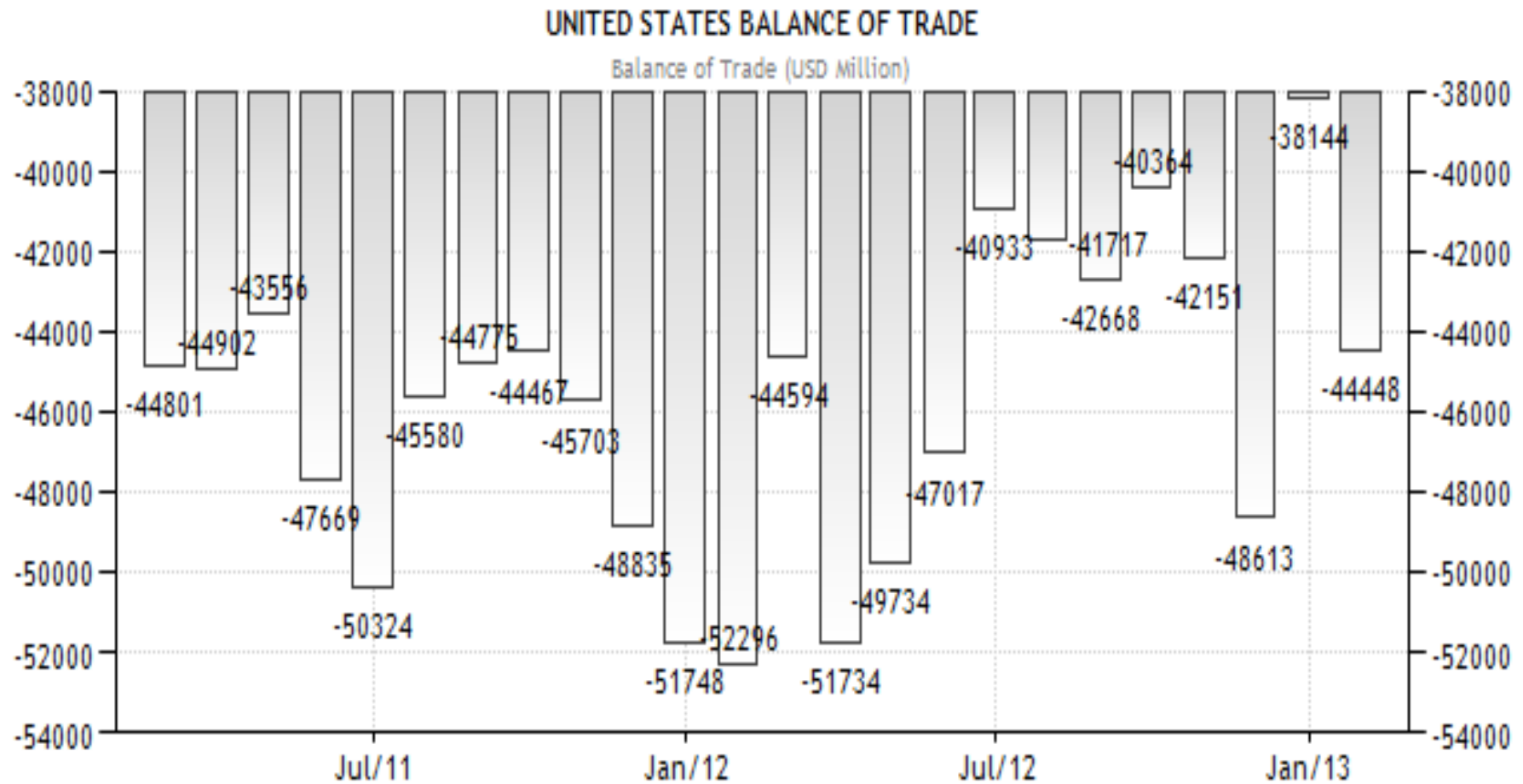


1 billion pounds

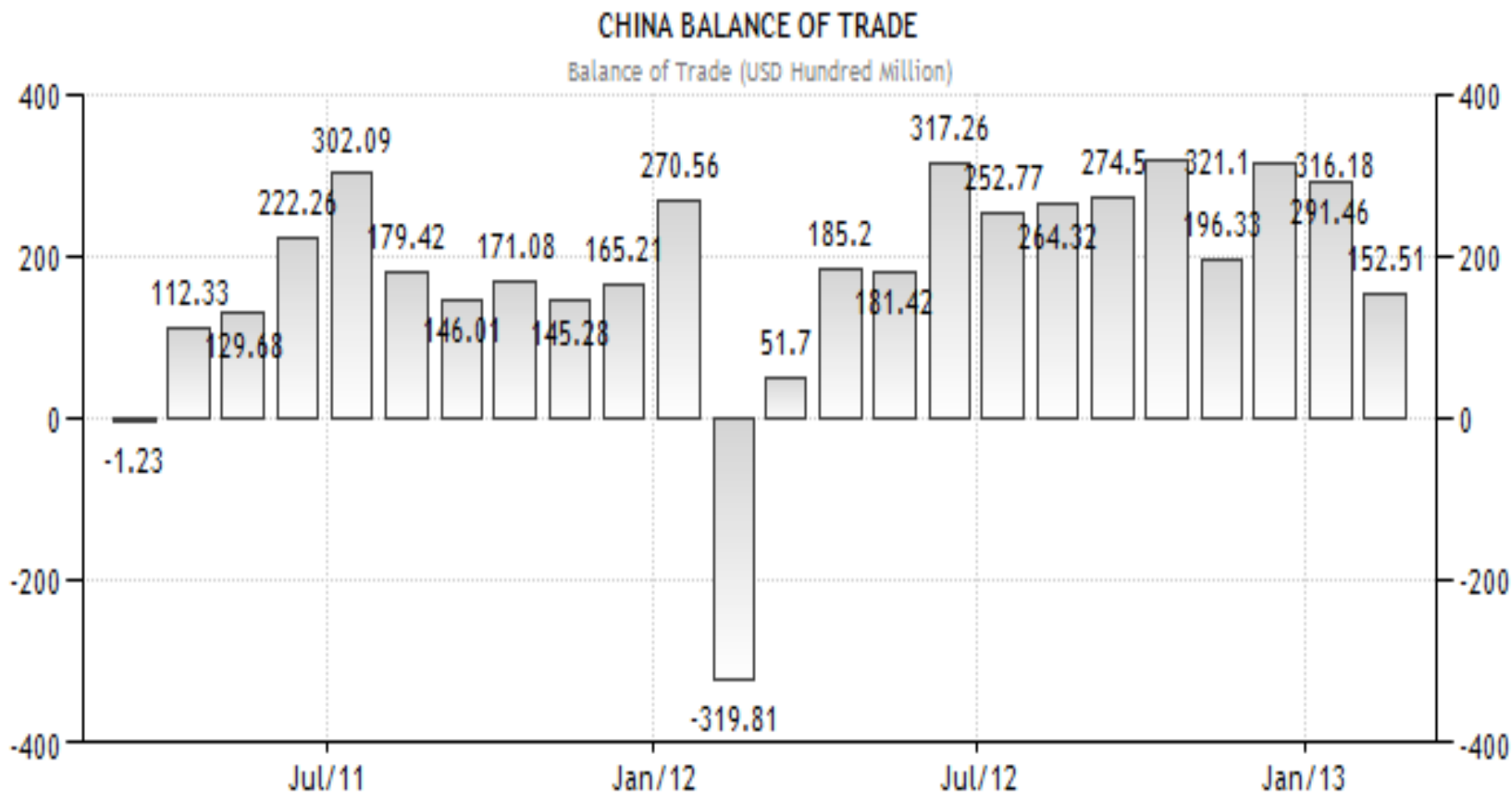


1 trillion pounds (thousand billion pounds)

United States Balance of Trade



China Balance of Trade



Should there Completely Free Trade with all other countries?



Arguments for Restricting Free Trade

- The Jobs Argument: Trade with other countries destroys domestic jobs.
 - Response: Might impose hardship in the short run, but in the long run, displaced workers would move to industries where comparative advantage exists.
- The National Security Argument: Protecting key industries (like steel, oil) is important to the security of our nation.

Arguments for Restricting Free Trade

- The Infant-Industry Argument: Temporary trade restrictions are necessary to help new industries (or older industries trying to cope with new conditions) get started and be able to compete with foreign competitors
- The Unfair-Competition Argument: Free trade is desirable only if all countries play by the same rules. Firms in other countries might be subsidized by government or have fewer regulations, etc.

Trade Restrictions

- Tariff: A tariff is a tax on imported goods. A tariff raises the price of the imported good above the world price by the amount of the tariff.
 - Who is hurt?
 - Domestic consumers pay more, foreign producers are hurt, foreign employees lose jobs and income and are less likely to buy our exports
 - Who is helped?
 - Domestic industries who are protected and their employees.

Trade Restrictions

- Import Quota: An import quota is a limit on the quantity of a good that can be produced abroad and sold domestically

Trade Agreements

- General Agreement on Tariffs and Trade (GATT)
 - Created after World War II in response to high tariffs imposed during the Great Depression
 - The rules established under GATT are now enforced by an international institution called the World Trade Organization (WTO).
 - Provides framework for negotiations
 - Resolves disputes between its members

Trade Agreements

- European Union
- North American Free Trade Agreement (NAFTA)
 - The United States, Canada, and Mexico is designed to eventually remove all barriers to trade among the three nations.

Review

- Explain how comparative and absolute advantage differ.
- Think of a product and think about its origin. How did comparative advantage allow you to get this product?

